Chapter 17

Compensation

> In his determination of our case the Financial Ombudsman directed our Financial Adviser to pay many hundreds of thousands of dollars to us but we received nothing as the company was in liquidation and the directors were all bankrupt. The company's professional indemnity insurance was pathetically inadequate and had long been exhausted.[1]

17.1 Investors caught up in the collapse of the MIS found that they had few if any available or affordable avenues to seek some form of restitution for bad advice and/or irresponsible lending practices. In this chapter, the committee examines the compensation mechanisms available to investors who, through poor advice or misleading promotion, have suffered financial loss.

Avenues for recompense

17.2 ASIC maintained that:

> Having efficient and effective dispute resolution and compensation mechanisms is integral to promoting the confident and informed participation of consumers in the Australian financial services system…[2]

17.3 The experiences of numerous retail investors in agribusiness MIS, however, exposed deficiencies in the mechanisms meant to provide redress for breaches of the law. For example, one couple stated that there was no recourse for the average investor, explaining:

> Lawyers' fees are hundreds and thousands of dollars. ASIC have done nothing. The Financial Ombudsman does nothing. What do we have left? Our voice now is through the press and imploring you, who are a representative of the people of Australia, to do something.[3]

17.4 Along similar lines, Greig and Bridget Allan noted that there was no compensation for small investors in the collapse of forestry MIS and other agricultural schemes. In their view:

> Litigation is fraught with expenses beyond the limits of small investors. Banks have enormous resources to see that all loans are paid in full for collapsed schemes.[4]

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1 Name withheld, *Submission 186*, p. 4.

2 *Submission 34*, paragraph 165.

3 Name withheld, *Submission 56*, p. [5].

4 *Submission 133*, p. [1].

17.5 An investment manager who has been attempting to assist a number of clients with investments in early Timbercorp forestry projects, Mr Jeff Chin, joined many other investors to highlight the difficulties investors have in seeking recompense for perceived shortcomings:

> The difficulties for growers in simply defending the claims in court include inexperience and the extremely high cost of access to justice. In some cases, it simply cannot be financed, whereas in others, the cost is disproportionately large and many multiples of the amounts in question (which is typical of the reason that the consumer protections were put in place in the first instance)…The Liquidators appear to be gaming this with their preference for the unduly legal approach and refusal to discuss.[5]

17.6 In his assessment, the most serious allegations appeared to involve breaches of existing regulations that centre on intermediaries who are bankrupt or have been in bankruptcy. According to Mr Chin, 'the issue is not that current regulations do not already prohibit such behaviour, it is that perpetrators simply ignore the existing requirements and there does not appear to be adequate compensatory arrangements in place'.[6]

Advisers—professional indemnity insurance and bankruptcy

17.7 ASIC noted that AFS licensees must have adequate arrangements for compensating retail clients and consumers for loss or damage due to breaches of the financial services laws and explained the compensation arrangements. For example, the Corporate Regulations 2001 mandate that an AFS licensee must have an 'acceptable contract' of professional indemnity (PI) insurance as 'the key form of compensation'.[7] According to ASIC, this PI insurance cover is required to:

a) be adequate, having regard to the licensee's business (the volume of business, the number and kinds of clients or consumers, the kind of business and the number of representatives) and the maximum liability to compensation claims that realistically might arise;

b) cover external dispute resolution (EDRs) scheme awards—currently, two ASIC-approved EDR schemes operate—the Financial Ombudsman Service (FOS) and the Credit and Investments Ombudsman (CIO);

c) cover fraud or dishonesty by directors, employees, other representatives and other agents of the licensee; and

5 *Submission 144*, p. [2].

6 *Submission 144*, p. [2].

7 *Submission 34*, paragraphs 181–182.

d) have a limit of at least $2 million for any one claim and in the aggregate for licensees with total revenue from financial services or credit services provided to retail clients and consumers of $2 million or less.[8]

17.8 PI insurance, however, has its drawbacks. ASIC noted that this insurance is designed to protect AFS licensees against business risk, but not to provide compensation directly to investors and financial consumers, explaining further:

> It is a means of reducing the risk that a licensee cannot pay claims because of insufficient financial resources, but has some significant limitations, including where there are insolvency issues, or multiple claims against a single licensee. In addition, directors may access PI insurance to defend legal proceedings, which may reduce the amount available for investors.[9]

17.9 According to ASIC, the gaps in, and caps on, PI insurance cover will 'inevitably remain a problem', given the limits on ASIC's capacity 'to compel commercial providers of the product to adapt it to a purpose different from and beyond the purpose for which it was designed'.[10]

17.10 Evidence to this inquiry highlighted the inadequacy of PI insurance for some of the financial advisers who recommended agribusiness MIS to their retail clients. A number of investors referred to their financial adviser opting to declare bankruptcy, thereby closing off any means for them to recoup losses they believed resulted from inappropriate advice or their adviser's misconduct. Indeed, by declaring bankruptcy, the adviser escaped litigation and left clients unable to recover their losses.[11]

17.11 Invariably, investors looking to receive compensation from their adviser for poor financial advice were disappointed. One such investor stated:

> The adviser had insurance but it was not enough to cover all the people suing them and they declared bankruptcy leaving us with no avenue for compensation. Our last resort is this class action against Bendigo/Adelaide bank. We started off with an unencumbered home and now we are in over one million dollars of debt with only one income and a young, growing family.[12]

17.12 Their account is similar to many others, who referred to the inadequacy of professional indemnity insurance.[13] A number of growers noted that the professional

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8 *Submission 34*, paragraph 184.

9 *Submission 34*, paragraph 186.

10 *Submission 34*, paragraph 187.

11 *Confidential Submission 116*, p. [1].

12 Mr Andigone Aguilar, *Submission 67*, p. 1.

13 Ms Michelle Johnson, *Submission 139*, p. [1]; name withheld, *Submission 168*.

indemnity their financial services provider had taken out was 'hopelessly inadequate'.[14] For example, one investor stated:

> Our Financial Planner was massively under-insured and he himself declared bankruptcy to avoid litigation to recover costs against him. We are left with no financial recourse against the financial planner and the legal avenues against the banks seem to be fruitless despite clear evidence of knowledge of the non-viability of the schemes they were funding.[15]

17.13 Another investor, referred to her adviser, Mr Holt, stating that it was hard to believe that he was allowed to trade with only a $2 million PI insurance policy for his business, which proved totally inadequate for his clients. Effectively, the clients were denied the opportunity to take legal action to recoup some of their losses brought about by his poor financial advice.

17.14 A financial adviser without financial backing means that even when an investor has received a favourable award from the Financial Ombudsman Service (FOS), the investor may not receive compensation. FOS is one of the two ASIC-approved EDR schemes.[16]

17.15 The experiences of clients of Mr Steve Navra demonstrated clearly the limited opportunities for obtaining any form of restitution. One such client explained that after the first successful FOS claim against Mr Navra, Mr Navra immediately 'declared bankruptcy, relocated to Melbourne and is now practicing "wealth education" seminars down there'. He noted further:

> At the time of the Great Southern demise, we even received a letter from ASIC advising us we had potentially been mis-sold Grapevine products by Steve and to take [it] up with the Financial Ombudsman—but to what purpose? Steve is bankrupt, had insufficient insurance to cover all our claims…and with this 'settlement' we would no longer be able to pursue via FOS anyway.[17]

17.16 Another couple had a similar experience. They had received a letter from ASIC advising them that they may have been given inappropriate financial advice. They subsequently lodged claims for compensation through FOS only, in their words, 'to be let down'. They explained:

> Just as our case was about to go to determination our financial advisor declared bankruptcy. Subsequently we sought private legal advice, at great expense, and are still awaiting an outcome as it appears our financial

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14 *Confidential Submission 134,* p. [4]; Ms Michelle Johnson, *Submission 139,* p. [1]–[2].

15 *Confidential Submission 116,* p. [1].

16 The current regulatory architecture of the financial services complaints resolution system has its origins in the 1997 Wallis Inquiry, which identified the need for low-cost means to resolve disputes. See Financial Ombudsman Service, *Submission 193*, p. 3.

17 Name withheld, *Submission 56,* p. [4].

> advisor only had about $2 million insurance cover and the insurer is able to employ delay tactics until the statute of limitations is up or we give up.[18]

17.17 Noting that there was already a professional indemnity requirement, the FPA asserted that it was 'effectively broken'. It suggested that ASIC has no way to check PI cover: that there are no checks to make sure it is adequate.[19]

Compensation scheme

17.18 ASIC recognised that the effectiveness of the existing mechanism intended to compensate investors was limited where the ASF licensee 'is insolvent and the PI insurance is not responding'. Put bluntly:

> In these circumstances there is generally no realistic prospect of investors obtaining any compensation.[20]

17.19 One investor suggested the need for a special compensation scheme:

> The amount of debt and financial hardship this has directly caused hard working Australians, some sort of compensation package for Timbercorp victims needs to be addressed and set up as it has affected so many families and put them on the path to financial ruin.[21]

17.20 Another couple also suggested that help was needed to introduce a compensation package for victims of Timbercorp who received bad financial advice and whose projects were managed poorly. They added:

> We can't be fully compensated for our total loss, as there is no amount of money that can restore our trust or health.[22]

17.21 Clearly, the incidence of uncompensated loss for investors in agribusiness MIS undermines public confidence in Australia's financial services system and enlivens the debate about the merits of introducing a last resort compensation scheme.

Report on compensation arrangements

17.22 Industry Super Australia acknowledged that many of those who had suffered financial loss because of their investment in MIS had not received compensation. It believed there was value in considering the recommendations arising from Mr Richard St John's 2012 report. Although not specifically addressing investors in failed MIS, Mr St John's recommendations have relevance. They included:

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18 Name withheld, *Submission 65,* p. [1].

19 Mr Neil Kendall, *Proof Committee Hansard*, 6 August 2015, p. 29.

20 *Submission 34*, paragraph 192.

21 Name withheld, *Submission 33*, p. [2].

22 Name withheld, *Submission 102,* p. [2].

- require licensees to provide ASIC with additional assurance that their professional indemnity insurance cover is current and is adequate to their business needs;
- more attention should be given, on a risk targeted basis and in conjunction with the level of their insurance cover, to the adequacy of licensees' financial resources to enable better management of risks and unexpected costs such as compensation liabilities;
- ASIC should take a more pro-active approach in monitoring licensee compliance with the requirement to hold adequate professional indemnity insurance cover and any new requirement in regard to financial resources, and in targeting licensees who are most at risk;
- to assist ASIC in playing a more pro-active role in administering the licensing regime with respect to compensation arrangements, consideration should be given to clearer powers to enforce standards and to sanction licensees who do not comply;
- in dealing with licensees who give up their licence or reduce the scope of their licensed activities, ASIC should seek where possible to secure ongoing protection for retail clients including by imposing appropriate conditions in relation to the termination of a licence or the amalgamation or takeover of a licensed business; and
- given their role in the regime for the protection of consumers of financial services, and marked increases in their jurisdiction, External Dispute Resolution schemes and ASIC should give more attention to the adequacy of the EDR scheme processes as those schemes grow beyond their origins as forums for small claims.[23]

17.23 With regard to introducing a last resort compensation scheme, Mr St. John urged caution. In his view, such a move at this stage would not address the underlying problems: that it would 'be inappropriate, and possibly counter-productive'. He explained:

> A last resort scheme would have the effect of imposing on better capitalised and/or more responsibly managed licensees the cost of bailing out the obligations of failed licensees. It would not work to improve the standards of licensee behaviour or motivate a greater acceptance by licensees of responsibility for the consequences of their own conduct. It could well introduce an element of regulatory moral hazard by reducing incentive for

23 Richard St. John, *Compensation arrangements for consumers of financial services,* April 2012, pp. 147–149, http://futureofadvice.treasury.gov.au/content/consultation/compensation_arrangements_report/downloads/Final_Report_CACFS.pdf (accessed 1 June 2015). *Submission 136,* p. 5.

> stringent regulation or rigorous administration of the compensation arrangements.[24]

17.24 According to Mr St John, deferring further consideration of a last resort scheme would be preferable pending the implementation of the measures he had proposed as well as other reforms now in train including FOFA.

17.25 The committee touched on the inadequacy of compensation mechanism in its 2014 report and has again received, and taken evidence on, this matter in its scrutiny of financial advice inquiry (SOFA), particularly a proposal for a compensation scheme of last resort. For example, consistent with the evidence relating to agribusiness MIS, Mr Craig Meller, AMP told the SOFA inquiry that some providers in the industry do not have adequate insurance arrangements. He recognised that it would be appropriate to have some sort of underlying safety net for those who have slipped through the system—'those who got a FOS determination and then, for whatever reason, were unable to be remunerated from the provider of advice'.[25] Mr Meller suggested that in conjunction with any consideration of a compensation scheme, consideration should be given to determining what the minimum levels of indemnity insurance should be and ensuring they are appropriate. He did note, however, that there are cases where insurance is not available, for example, a business cannot get insurance for committing fraud. In AMP's view:

> …there should certainly be consideration that minimum capital requirements could be put in place, to ensure that the number of people who slipped through the safety net and were not remunerated could become *de minimis*. In that case, it would be much easier to build an industry coalition to find a way to cover such a compensation scheme.[26]

17.26 From her unique position as the independent hardship advocate (IHA), Ms Lowe had no doubt that a significant number of the people she was working with should receive compensation. She noted that at best the advice they received to invest in Timbercorp appeared 'completely inappropriate, at worst, deceitful', adding:

> It is equally clear that the protection mechanisms in place are not adequate to provide that compensation.[27]

17.27 Ms Lowe considered the avenues open to the victims of bad financial advice and concluded:

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24 Richard St. John, *Compensation arrangements for consumers of financial services,* April 2012, p. 143, http://futureofadvice.treasury.gov.au/content/consultation/compensation_arrangements_report/downloads/Final_Report_CACFS.pdf (accessed 1 June 2015).

25 *Proof Committee Hansard,* Senate Economics References Committee inquiry into the Scrutiny of Financial Advice, 10 August 2015, 10 August 2015, p. 2.

26 *Proof Committee Hansard,* Senate Economics References Committee inquiry into the Scrutiny of Financial Advice, 10 August 2015, pp. 1–2.

27 Ms Catriona Lowe, *Submission 200*, paragraph 4.

> Whilst many victims of poor adviser conduct may well succeed in a complaint to either the Financial Ombudsman Service or Credit and Investments Ombudsman, a favourable determination must then be satisfied. Neither adviser solvency nor professional indemnity insurance has proved adequate to this task. In the case of PI, levels of cover are either woefully inadequate to compensate loss or too narrow in scope to answer at all. Experience in other insurance markets such as public liability and home building insurance suggest that endeavours to mandate scope or depth of PI will not succeed in the medium to long term.[28]

17.28 In her view, a last resort compensation scheme should exist to provide redress for consumers suffering loss as a result of inappropriate or negligent financial advice.[29] Ms Lowe informed the committee that such a scheme has 'the capacity to provide a real remedy to people whose lives have been blown apart'.[30]

17.29 The difficulty then is to find the funding to ensure proper compensation. A number of witnesses before the SOFA inquiry referred to this problem. AMP observed:

> The challenge we have, as a large corporate that naturally is very well capitalised and essentially self-insures, is to ask ourselves if it is appropriate that the shareholders and the customers of AMP end up paying for the incompetence of others in the industry. While there is a good argument for that broadly being for the better good of the industry, we also want to ensure that it did not create those moral hazards and so we would be a very willing participant in further consideration of this scheme.[31]

17.30 In effect, according to AMP, such a scheme would never apply to its customers.[32] AMP suggested that it would be timely to revisit the findings of Mr St. John's report on a statutory compensation scheme.[33]

17.31 Mr Andrew Hagger, NAB, similarly recognised that some people, who have dealt with a small firm, go all the way through a system to FOS, receive a judgement

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28 Ms Catriona Lowe, *Submission 200*, paragraph 5.

29 Ms Catriona Lowe, *Submission 200*, paragraph 6.

30 Ms Catriona Lowe, *Submission 200*, paragraph 7. See also, Ms Lowe's observations in paragraph 11.33. For example she stated, while 'industry based EDR theoretically provides this redress for poor adviser conduct, in reality this redress is stymied by the limitations of adviser solvency and PI insurance.

31 Mr Craig Meller, *Proof Committee Hansard*, Senate Economics References Committee inquiry into the Scrutiny of Financial Advice, 10 August 2015, pp. 1–2.

32 Mr Craig Meller, *Proof Committee Hansard*, Senate Economics References Committee inquiry into the Scrutiny of Financial Advice, 10 August 2015, pp. 1–2.

33 Mr Craig Meller, *Proof Committee Hansard*, Senate Economics References Committee inquiry into the Scrutiny of Financial Advice, 10 August 2015, p. 2.

in their favour, which is then not paid. Whereas, in his words, if NAB do the wrong thing, customers can be compensated.[34]

17.32 Mr Nicholas Moore, Macquarie Bank, also referred to people found to be victims who, despite FOS determinations, have not received compensation. He agreed that such people deserve justice but it has not been delivered to them. Mr Moore understood the importance of the industry having professional standing, noting:

> A normal industry professional body does have some sort of compensation scheme; we see it in the law profession with solicitors and with other professional bodies. We would see that, with this part of the evolution of the whole financial planning industry, it would not be an unexpected outcome in terms of ending up here.[35]

17.33 According to Mr Moore, moral hazard is an important concern to bear in mind, but that Macquarie thought that a compensation scheme was an issue that certainly needed examining. He referred to other industry bodies where similar sorts of schemes were in place, so, in his view, there certainly were 'precedents for it out there'.[36]

17.34 Mr Graham Hodges, ANZ, agreed that there was a gap in respect of a scheme of last resort or better arrangements around public indemnity insurance to make sure people do not fall through the cracks. In his view:

> …the problem is that you have myriad players, many of whom do not have much financial means or much protection in terms of insurance. If there is a systemic issue within that planner group then there is a likelihood that that planner group will not have sufficient financial muscle to right the wrong.[37]

17.35 Referring specifically to investors in the failed Timbercorp schemes, he explained further:

> …the issue for many of these people is that the limited amount of insurance or personal indemnity insurance these practices had was gone very quickly and there were many, many clients affected. So there is nowhere for these people to go other than, as a number did on several occasions, to work through a class action. In the Timbercorp case they lost comprehensively on two occasions, at further cost and with further delay and at further cost to

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34 *Proof Committee Hansard*, Senate Economics References Committee inquiry into the Scrutiny of Financial Advice, 21 April 2015, p. 45.

35 *Proof Committee Hansard*, Senate Economics References Committee inquiry into the Scrutiny of Financial Advice, 21 April 2015, p. 21.

36 *Proof Committee Hansard*, Senate Economics References Committee inquiry into the Scrutiny of Financial Advice, 21 April 2015, p. 21.

37 *Proof Committee Hansard*, Senate Economics References Committee inquiry into the Scrutiny of Financial Advice, 21 April 2015, p. 24.

> the individuals, because they were advised by the lawyers not to pay their loans.[38]

17.36 ANZ's preferred option would be for organisations that have sufficient financial strength and can pay out as required for mistakes to be allowed to effectively self-insure because they have the capital behind them. Organisations that do not have sufficient financial strength, however, 'would be required to take out some sort of insurance'.[39] He also recognised the issues of moral hazard but thought they could be minimised and would probably be a lesser issue if planners' insurance costs rose as a result of their mistakes. Mr Hodges elaborated:

> When you meet with the people who have gone through the extreme hardship that some have, where there is no-one to go to, you can see why it is worthwhile putting in place a scheme, even if there is some reduced risk of moral hazard, I believe.[40]

17.37 ASIC supported 'consideration' of the introduction of a limited statutory compensation scheme. It noted that it does not have the power to award or compel an AFS licensee to pay compensation where the licensee has caused direct financial loss to retail investors. ASIC suggested that an independent 'statutory compensation scheme would supplement PI insurance and the formal determination of claims by EDR schemes'.[41]

17.38 As a final observation on the need for a compensation scheme of last resort, Ms Lowe noted that the problem encountered by the victims of unsound financial advice was significantly broader than Timbercorp. She referred particularly to evidence submitted to the committee's inquiry into the scrutiny of financial advice.[42]

Committee view

17.39 Clearly, the current system for compensating retail investors who have suffered financial loss as a direct result of inappropriate financial advice is failing the investors. Despite the work of FOS, many people who have received favourable FOS determinations are unable to receive fair compensation because their adviser had inadequate insurance and, in many cases, declared bankruptcy.

17.40 In light of the evidence, the committee recognises that some form of compensation scheme for the victims of bad financial advice warrants much closer

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38 *Proof Committee Hansard,* Senate Economics References Committee inquiry into the Scrutiny of Financial Advice, 21 April 2015, p. 25.

39 *Proof Committee Hansard,* Senate Economics References Committee inquiry into the Scrutiny of Financial Advice, 21 April 2015, p. 25.

40 *Proof Committee Hansard,* Senate Economics References Committee inquiry into the Scrutiny of Financial Advice, 21 April 2015, p. 25.

41 *Submission 34,* paragraph 223.

42 Ms Catriona Lowe, correspondence to committee, January 2016, paragraph 6.

consideration. The committee resolved that, rather than duplicate work and examine this matter as part of its MIS inquiry, it would investigate a compensation scheme of last resort as part of its SOFA inquiry. One of SOFA's terms of reference goes directly to this matter—whether existing mechanisms are appropriate in any compensation process relating to unethical or misleading financial advice and instances where these mechanisms may have failed.